

PUBLICATION

Required Minimum Distribution Failures May Result in Tax Sanctions and Plan Disqualification

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Retirement plan participants, IRA owners and employers that sponsor tax-qualified retirement plans should be aware that tax laws include required minimum distribution (RMD) rules. Those RMD rules affect when benefit payments must begin, the period over which they may be paid, and impose sanctions for failure to satisfy those rules. For the plan participant or IRA owner, an additional tax equal to 50 percent of the missed payment may be imposed; for an employer-sponsored retirement plan, the plan may lose its tax-qualified status.

When RMD Must Begin

The following discussion addresses rules that apply to account balance arrangements, such as 401(k) plans, profit sharing plans and IRAs. Similar rules apply to defined benefit pension plans, except that the amount required to be distributed each year is determined in a somewhat different manner. In addition, other rules govern the required distribution of these plans and IRA balances after the death of the account or IRA owner.

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For a 5 percent business owner and any IRA owner, the RMD must begin no later than April 1 following the end of the calendar year in which the individual attains age 70½, regardless of retirement status.

RMD Calculation and Payment Period

The RMD is calculated using the account balance of the last valuation in the year before the distribution year and using Treasury Department life expectancy tables. With regard to the first year for which a distribution is required (e.g., the year an IRA owner attains age 70½), the RMD can be delayed until April 1 of the following year. The RMD for each subsequent year must be received by the end of that calendar year. Note that this generally requires two distributions in the year after attaining age 70½ or retiring, as applicable - one distribution for the year of attainment of age 70½ (by April 1 of the next year) and a second distribution for the year after (by December 31).

In general, the Treasury Department life expectancy tables will permit the account or IRA to be distributed over the lifetime of the plan participant or IRA owner. Although lifetime distributions may be made more rapidly, compliance with the RMD rules requires that the distribution made during each year be in an amount at least

equal to the minimum amount described above. While some IRA custodians will calculate the amount of the RMD for you, you are ultimately responsible for compliance with the RMD requirement for each year.

Sanctions for RMD Failures

In addition to the regular income tax which may be payable on each RMD, if you fail to receive an RMD in any year the IRS may assess an additional excise tax equal to 50 percent of the difference between the amount that was required to be distributed for the year and the amount that was actually distributed. That undistributed amount is referred to as an "Excess Accumulation." The Excess Accumulation and the resulting additional excise tax are required to be reported by the plan participant or IRA owner on Form 5329, as an attachment to the individual's Form 1040 tax return for the year in which the RMD failure occurred, or separately filed if no Form 1040 is filed. Once an RMD failure is discovered, the individual should take the remaining RMD amount at that time. The additional amount will not count toward the RMD for the year of distribution, but will be taxable for income tax purposes in the year it was received. Just by way of example, assume that the 2010 RMD for an IRA owner is \$25,000. Assume also that the owner receives only \$20,000 by December 31st of 2010 and receives an additional \$5,000 on February 1, 2011. The 2010 additional tax on Excess Accumulation will be \$2,500 (50 percent of \$5,000) and is due with the IRA owner's 2010 income tax return.

Possible Sanction Waiver

Under Code Section 4974(d), the IRS may waive or reduce the Excess Accumulation excise tax if the participant shows reasonable cause for failure to receive the entire RMD, along with an explanation of any efforts to correct the error as soon as it was discovered. If you believe that you qualify for a reasonable cause waiver of the excise tax you should file Form 5329 with the required explanation of reasonable cause, the amount of the penalty you wish to have waived, and the amount of additional tax you intend to pay.

In the example above, if the IRA owner has a reasonable explanation for his failure to receive the entire RMD, he should attach that explanation and state that he did receive the additional amount of the RMD on February 1, 2011. The IRA owner should request a waiver of the entire \$2,500 penalty and include an additional tax of zero. The IRS will then review the Form 5329 and the IRA owner's explanation and determine if, or to what extent, it will waive the additional excise tax.

Alternatively, the IRS has procedures in place to allow a plan sponsor to request a waiver on behalf of the affected participant(s). There are no similar procedures for an employer to request a waiver on behalf of an IRA owner.

Plan Sponsor

If a plan sponsor fails to distribute the entire RMD in any year, the tax-qualified status of the plan can be lost. For this purpose, the plan sponsor can correct an RMD failure with an application made through the IRS EPCRS or VCP program, or by self-correction if the correction is made within two years after the plan year in which the violation occurs. If the plan sponsor applies for EPCRS or VCP relief and requests a waiver of the 50 percent additional tax then, at least based on IRS waivers in the past, the sponsor should have a good chance of obtaining the waiver for affected participants.

Summary

Failure to comply with RMD rules can have significant tax and qualification consequences. Should you have any questions or wish to discuss any aspect of the RMD rules, please contact any of the attorneys in the Firm's Tax Department.

